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Desmond Lachman suggested ten questions for this seminar. I will focus on two:

- A. China's current macroeconomic situation.
- B. Exchange rate management.

At end I will offer a few comments on China's role in global adjustment.

A. China's current macroeconomic situation.

1. Is the economy still overheated?

Answer: *not as badly as a year ago*. But it is too early to relax aggregate demand management. Some further monetary and fiscal tightening is indicated; exchange rate action would be helpful, as I will discuss later. The more China can rely on indirect macro controls instead of direct administrative measures to manage aggregate demand, the better the prospects for market reforms.

The CPI and indicators of excessive or unbalanced investment growth have improved since the middle of 2004, but underlying financial system problems have not been conquered. Moreover, domestic credit expansion turned up again in November, housing prices continue to rise rapidly and speculative real estate investments continue. Bubble conditions in the housing sector are developing in several cities. But, as we all know, a bubble isn't a bubble until it bursts.

Two thousand three (2003) and the first half of 2004 saw a veritable orgy of domestic bank lending and investment in China, some of it wasteful, contributing to sharp global price hikes for many commodities and services such as sea freight. GDP growth since 2002 was almost certainly higher than the reported rates. The situation resembles the previous overheating cycle of 1992-96, but there are two important differences:

- a) Domestic inflation in China, as measured by the CPI, remained surprisingly modest during the current cycle; and
- b) International spill-over effects of the current cycle were much greater than last time. This was due to the larger relative size of China's economy and its much greater openness than 10 years ago.

The first point requires clarification. The CPI, which fell below 3% (yoy) in recent months, stayed below 6% (yoy) during the present cycle, even at the peak. By contrast, CPI inflation peaked around 26% during the previous cycle, in 1994. This striking difference is due, in part, to the fact that the economy was much more open in recent years than it was ten years ago; consequently, excess demand could be more easily satisfied through additional imports. China's import growth in 2003 and 2004, over 30% on average p.a., was indeed phenomenal and exceeded export growth for most of this period. However, this is only part of the explanation. Two other factors deserve attention:

- a) The low weights assigned to several goods and services included in China's CPI – in particular housing, medical care and education - are no longer realistic. Since the prices of those goods and services are known to have risen much faster than the average price level, the CPI understates inflation in China. Upstream price indices, such as the producer price index and the corporate goods index show much steeper price increases since the beginning of 2002 than the CPI. Only the raw materials price index has stabilized or declined in recent months as a result of the government's clamp down on investments in basic industries.
- b) The rising CPI in 2003 and early 2004 was in fact mainly due poor grain harvests in 2003 (following 4 years of declining production). Similarly, the fall in CPI from around the middle of 2004 was mainly due to excellent grain harvests that year.

2. What did the government do to cool bank lending and reduce wasteful investment?

When the government became convinced in early 2004 that things were getting out hand, it tried to slow bank lending and cut investment projects selectively, mainly through administrative measures, which were introduced in April. As a result, investment in basic industries, such as steel, aluminum and cement cooled down quickly and significantly. The import growth rate dropped and raw material prices stabilized. The worst investment excesses have been dealt with, but I am not convinced that the overheating cycle is fully under control. This is not a time to relax. After a slowdown in money and credit expansion in Q2 and Q3 of 2004, lending picked up again in November. Inflation, even the CPI, may turn up again in the months ahead, because most upstream price indices, although easing a little in recent months, remain stubbornly in the 8% range, while housing prices in the 37 largest cities continue to rise at 8-12% p.a. This may translate into higher consumer prices later, even if there is no problem in agriculture. China may be heading for more trouble, including a serious housing bubble. Speculative housing construction is continuing.

3. What happened to NPL ratios in the banking system and what lies ahead?

Most of the increase in lending in 2003 and 2004 did *not* come from the four large state-owned commercial banks, but from a large number of city commercial and other banks, most of them owned by lower-level governments. As a result of this important, but little

noticed shift in the distribution of China's banking sector assets, the combined share of the "big four" in total outstanding loan portfolios fell to around 50% by the middle of 2004, from a little over 62% only 3 years earlier. At least two of the four (BOC and CCB) are now more cautious in their lending than in the past; they are preparing for listing in Hong Kong and New York (as well as domestically). They are actively seeking strategic international minority partners prior to listing and are under intense scrutiny by international auditors (Ernst & Young and KPMG). ICBC is likely to follow on this path soon. All three - especially CCB and BOC - have dramatically reduced their NPL ratios in 2003 and 2004 as a result of higher profitability and partial recapitalization by the government.

The shift in banking system assets towards smaller banks also means that, in the event of a new wave of NPLs, as must unfortunately be anticipated, many of the problems will be concentrated in relatively small local banks. It remains to be seen how the central government will then react. Bank mergers and bankruptcies will probably increase. I cannot imagine that the central government will afford China's increasingly numerous small local banks the same protection as it affords the big four. It is perhaps with the risks facing smaller banks in mind, that the government introduced a generalized deposit insurance scheme in September of 2004, for the first time.

4. How high is China's investment/GDP ratio and is it sustainable?

My comments on the CPI illustrate why we cannot always rely on China's official statistics for a meaningful assessment of economic developments. The same applies to investment and GDP statistics. Several analysts have expressed concern about the sustainability of China's unusually high and still rising fixed asset investment/GDP ratio. These concerns are justified if the investment and GDP figures could be relied upon to tell a true story. Unfortunately that is not the case. China's statistics underestimate GDP by a significant margin (some analysts say by 30-40%) and probably overstate investment. Consequently, the investment/GDP ratio is lower than official numbers suggest, even though investment *growth* rates may be accurate.

Let's first look at GDP. Both the size of GDP and the rate at which it is currently growing are underestimated. With regard to the absolute size of China's GDP (measured at market exchange rates) there are two complications:

- a) In its annual statistical yearbook, NBS publishes two figures for GDP, one based on production accounts and the other based on expenditure accounts. For 2003 the second number was 3.6% larger than the first. For historical reasons, the first number is the basis for China's official GDP *growth* calculations. In theory, the two GDP figures should be the same, but in practice they aren't, because of statistical discrepancies. GDP based on production accounts used to be bigger than the expenditure-based numbers. The reverse was true after 1995. Expenditure-based national accounts are a better basis for estimating GDP and GDP growth.

- b) More importantly, the NBS data base for measuring value added by service sectors and for estimating imputed consumption is out of date. Many non-traditional service sector activities are not captured or seriously underestimated by the current statistical system, including e.g. private sector transportation, paid-for education, paid-for medical care and owner-occupied housing. Similarly, most informal sector trade and manufacturing are not reflected in official GDP statistics. Finally, underreporting of income is encouraged by China's high corporate tax rate (33%) and a high top marginal tax rate for personal income (45%). The underestimation of China's GDP increased as the economy became more privatized and diversified. It is totally implausible that the share of services in GDP remained more or less unchanged (at around 33%) since 1991, as the official statistics indicate. My guess is that China's GDP for 2003 measured on expenditure basis was probably closer to US\$2 trillion than the officially reported US\$1,468 trillion.

Let's now look at China's investment statistics. NBS uses two investment concepts: (1) total fixed asset investment; and (2) gross capital formation. The former statistic is provided monthly, quarterly and annually; it is a number that is used by some economic analysts for calculating the investment/GDP ratio. This is incorrect, because it includes the price of unimproved land and other existing fixed assets. The correct number for calculating China's investment/GDP ratio is the one for gross capital formation in the national accounts on expenditure basis. This number nets out the value of unimproved land and other existing fixed assets and allows for some other corrections. The official number for gross capital formation in 2003 was almost 8% lower than the official number for total fixed asset investment.

If China's GDP is about one third larger than the official statistics indicate, the investment/GDP ratio in 2003, using official numbers for gross capital formation, was not 42.3%, but about 32%, far below the record 43.5% that was recorded in 1993.¹ The official investment/GDP ratio for 1993 may, of course, also have been overstated, but the required adjustment would be smaller than for 2003, because distortions caused by underestimating service sector value added and excluding informal sector activities, would have grown progressively worse during the past decade.

My conclusion therefore is that China's current investment/GDP ratio, though high by international standards and still rising, has not reached an unsustainable level. I do not see a reason to worry about the overall ratio as such. It will probably rise further before it peaks in the years ahead.

One interesting, hidden implication of a lower overall investment/GDP ratio is that TFP growth rate is proportionately higher. This is good news for China, because it means that growth is more driven by productivity improvements than most analysts think.

¹ It is possible that, like GDP, investment numbers are also underestimated, and for the same reasons: some investments in services and informal sectors are not captured by official statistics. However, correcting for this would not raise the investment/GDP ratio to the official number (42.3% for 2003), because incremental capital-output ratios in those sectors are typically much lower than the national average ICOR.

5. Is there nothing to worry about with regards to China's investments?

Yes, there is. I am not only concerned about speculative investment in housing, but also about investment *quality* in general. In spite of otherwise successful government efforts to curb wasteful investment in certain basic industries, a lot of investment of doubtful quality is still going on elsewhere in the economy. For example, there is a high probability of excess capacity developing in the automobile industry. Production capacity is projected to rise to 15 million units p.a. before the end of this decade. It is very unlikely in my opinion that domestic demand will keep pace with production capacity in this time frame. Serious pressures are likely to develop, including falling profit margins and attempts to export cars at low prices.

The automobile industry example illustrates problems that seem to be developing in other sectors as well. Some of these problems are due to the unreformed nature of an important part of China's domestic banking system. I would like to highlight two factors:

- a) The fact that official bank loans are much too cheap – most current lending rates, although mildly positive with respect to the current (official) CPI, are significantly negative with respect to upstream inflation indices and expected price increases. This is particularly noteworthy in the housing sector.
- b) Bank supervision in China, though improving, remains partly dysfunctional. It is still possible for some segments of the banking system to lend indiscriminately and to ignore the build-up of NPLs on their balance sheets. The other side of this coin is, of course, that politically important, but inefficient SOEs, still find it possible to shift their losses to the banking system.

These two problems used to be largely internal to China's economy. But, with China's growing relative weight in the global economy and international trade, the unreformed nature of China's financial system is increasingly becoming a cross-border problem as well.

B. Exchange rate management

1. Is China's currency undervalued?

Yes, by most standards it is undervalued, but not by much. Some argue that the exchange rate is not undervalued, because the most important single indicator, China's current account balance shows only a small surplus (probably less than 2.5% of GDP in 2004). Others argue that it cannot be measured, because China's capital account is officially still closed.

My preferred way of assessing an exchange rate's under-or over-valuation is the "basic balance" method. China currently has a "basic balance" surplus of around US\$90 bn

(about 5% of GDP). To bring this surplus down to around US\$20 billion (to allow for a modest increase in reserves), a small revaluation of the RMB (4-5%) seems to be in order.² It is not in China's interest to have a large basic balance surplus. However, flexibilization of China's exchange rate regime is in my view a higher policy priority than currency appreciation.

2. Why is it in China's interest to adopt a more flexible exchange rate system?

- a) Fixed rate systems are potentially dangerous if maintained too long. Lessons of the Asian financial crisis of 1997/8 are clear in this regard.
- b) It gives China greater freedom in monetary policy, which is important for a large economy with an economic structure that is very different from that of the US. Greater freedom in monetary policy will not only make it easier to manage aggregate demand, but also to develop domestic capital markets and thus promote *domestic* financial intermediation, which is critical for future development.
- c) Under a fixed exchange rate system it is very hard to control the real effective exchange rate (which is more important than the nominal rate). A flexible rate system will allow for quicker and smoother adjustment to changing balance of payments conditions than a fixed rate system.
- d) It should make it easier for China to avoid excessive reserve build up.

3. Does China "manipulate" its exchange rate?

In a purely technical sense, yes. Like many other countries in East Asia, China prefers to maintain a relatively low exchange rate to promote exports and employment. I have trouble, however, with the use of the word manipulation in a legal accusatory sense in this context, as if China were somehow violating international law. The choice of a fixed exchange rate regime at the present level of 8.28 was a logical, legitimate and wise choice when it was made (December 1997); it helped stabilize regional currency markets during the Asian financial crisis. China was in fact applauded by the international community for its constructive exchange rate policy at the time. So, when did China's exchange rate policy become unconstructive or manipulative?

Surely, the transition from constructive to allegedly unconstructive or manipulative behavior wasn't caused by anything China did. If I had to identify one single factor that triggered China's alleged shift into manipulative behavior, it is US fiscal policies from 2001. That, more than anything caused a deepening of the US current account deficit and growing bilateral trade imbalance with China. Another factor was the sudden turnaround in international expectations concerning the value of the RMB. Prior to 2002 most people

² It is extremely difficult to determine empirically the relationship between changes in the exchange rate of a country and changes in its basic balance. The exchange rate is almost never the only factor that changes, not even in the short term. Many other economic factors (such as changes in domestic monetary, fiscal and trade policies), as well as political factors influence changes in a country's basic balance.

expected a devaluation of China's currency. When expectations turned around, China had to cope with huge inflows of unwanted speculative capital. It would have been unwise for China to respond to this inflow with a revaluation. It had in fact little choice but to buy the excess foreign exchange and accumulate reserves. This, more than China's basic balance surplus explains the huge build up of reserves since the beginning of 2002.

As a footnote on the question of "manipulation", a comment on the US-based NDF market for RMB. Although transactions are local and in US dollars only, NDF market indicators do steer speculative capital flows in or out of China. In spite of official controls, China's capital account has become very leaky. Domestic dollar deposits in the NDF market are FDIC protected. In this way, the US unintentionally facilitates speculation against the RMB.

4. When should China change its exchange rate regime?

China has decided in principle *and announced* its intention to change the system. The question of timing is a delicate one. The issues are complex. For example, China does not want to reward speculators or trigger new currency speculation either by its own companies and residents or by foreign interests. Also, it wants to make sure that any change in rate and/or regime will not be followed by destabilizing social consequences for China or the region. China's financial authorities realize that an appreciation of the real effective exchange rate is all but unavoidable when the country has both current account and capital account surpluses. They presumably prefer to be in the driver's seat and manage the nominal rate, rather than be forced to accept real appreciation through higher domestic inflation. That's about all I can say on timing. My expectation is that change will come before long.

5. If flexibilization is in China's interest, why haven't they moved already?

In considering this question it is worth remembering that China did in fact adopt a flexible rate system when it unified the earlier multiple exchange rate system on 1 January 1994. At that time the authorities announced that they would be guided by market forces in managing the new exchange rate. Most people in China and abroad expected the new unified rate of 8.7 to begin depreciating soon. This expectation was based on the fact that China had a current account deficit in 1993, while domestic inflation was running much higher than in the US. However, to almost everybody's surprise, the rate began moving in opposite direction on the Shanghai Interbank Foreign Exchange Market, which had been created that year to help guide the authorities in managing the float.

The reason for this was a dramatic turnaround in China's trade balance in 1994 due to a veritable explosion of new investment in export industries – much of it FDI-financed – in preceding years, following Deng Xiaoping's famous "visit to the South" in early 1991. The unexpected *nominal* appreciation of the RMB – about 5% in fourteen months – caused a problem for China, especially since the *real effective* exchange rate was appreciating even faster. To avoid a further erosion of export competitiveness the

authorities decided to fix the nominal rate around 8.3 by instructing the central bank to buy any excess dollars offered at that rate. The trading band was further narrowed and the rate was effectively fixed at 8.28 in December 1997 in response to the Asian financial crisis that had erupted earlier that year. China never announced a change in its exchange rate regime, however. Officially, China still has the managed float system that was introduced on January 1, 1994. We should therefore not be surprised if some day, the RMB starts moving away from the current 8.28 rate without prior announcement of regime change.

Changing a de-facto fixed exchange regime that has served China's interests well for a decade is a momentous decision. Many unknowns and risks have to be considered. It is only natural that opinions in China on this topic are as divided as international opinions are. At a recent conference in China, top financial leaders were urged by several prominent American economists, including a Nobel laureate, not to change the present rate or system, because it would be very risky or too costly. Others recommended an immediate revaluation of around 15%, combined with simultaneous or later system change.

Other factors explaining China's reluctance to move on the exchange rate:

- a) The need to create as much employment as fast as possible in the modern sectors of the economy. Open unemployment in urban China is already high. Social safety nets are not yet fully functional. Jun Ma, head of research at Deutsche Bank in Hong Kong estimated recently that a 10% revaluation of the RMB would force the closure of 50,000 low-margin enterprises and one million lay-offs in the export sector.
- b) Agenda overload. In the wake of WTO accession, China is implementing myriad legal, institutional and economic policy changes required to comply with WTO conditions. Few countries ever had to cope with as much fundamental change as China is trying to manage today.
- c) Conflicting domestic economic signals and interests. There are still major structural imbalances in the economy and some domestic markets remain highly segmented. For example, light manufacturing for export is facing declining profit margins and price deflation while other industries enjoy high profits, partly as a result of inflation in their sectors. What is good for traditional grain producing areas (where a lot of rural poverty is concentrated) may be bad for manufacturing. At the macro level, China's economy is hard to manage: market reforms are incomplete, unemployment is high and social safety nets are inadequate.
- d) Concern that domestic derivative markets are insufficiently developed to cope with the huge demand for hedging against currency risk that will inevitably follow exchange rate flexibilization. The lessons of 1994 have made the Chinese doubly cautious in this regard. Ironically, there were no derivative markets in 1994 when they introduced a managed float.

- e) Convenience. Much of China's trade with countries in Asia is invoiced in US dollars. This is a practical convenience that may be lost once a more flexible regime has been put in place.

6. What is in it for the US?

Not a lot. Even if China revalued the RMB by 15%, as recommended by some analysts, it would not reduce the bilateral trade imbalance by more than US\$20-25 billion and it would do little to create or protect jobs in the US. US import demand may simply shift to alternative foreign sources of supply. To the extent this happens, the US would in fact suffer a net welfare loss, because the alternative foreign supply sources are more expensive than China. Isolated appreciation of the RMB isn't very helpful to the US for three additional reasons: (1) most of the goods imported from China do not directly compete with US manufacturers, (2) perhaps as much as 25-35% of China's exports to the US originate from US-invested companies located in China, and (3) the margin of value added in China for most exports is quite small. With regards to the last point, it is important to note that US importers and domestic distributors of imports from China often account for a larger share of the final retail price in the US, than the manufacturers in China. Consequently, the price (exchange rate) elasticity of US import demand for goods from China is on average probably quite low.

For the protection of US economic interests (jobs and trade), it is in my opinion more important to urge accelerated financial sector reform and better IPR protection in China than to press for an appreciation of the RMB.

Looking at the situation from a global perspective, it is important to note that China accounts for only a small proportion (5-6%) of aggregate current account surpluses in the world and hence of the US current account deficit (which accounts for the lion share of aggregate global deficits). Non-China Asia accounts for over 50% of global current account surpluses, the Euro zone for about 25% and oil exporters for most of the remainder.

The story about the relative unimportance of the RMB/US\$ exchange rate for the US would be different if an appreciation of the RMB were associated with a further appreciation of the Japanese Yen and appreciation of other East Asian currencies. Most or all are undervalued by the basic balance method. If all appreciated as part of a coordinated move, it would be harder for the US to shift supply sources and the likelihood of a positive effect on global imbalances would be greater.

How do we get coordinated exchange rate action in East Asia? It will be difficult, but the chances would improve if we could engineer something like a new Plaza Accord, preferably a *Plaza Plus* Accord. Global trade imbalances are now so large that exchange rate action by itself, even if coordinated, may not be enough. The *Plus* stands for supplementary *structural* action. It would be very helpful if, as part of an international

agreement to redress global imbalances, China would accelerate financial sector reform (to reduce the risk of cyclical overheating), Europe would accelerate labor market reform, relax monetary policy and modify the fiscal Stability Pact, Japan would intensify corporate reform and accelerate bank recapitalization, the US would promote domestic savings (both public and private), facilitate industrial restructuring and adopt more sensible energy pricing policies, while India would accelerate infrastructure investment and cut bureaucracy.
